United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

No. 75-6066

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

SECURITIES INVESTOR PROTECTION CORPORATION,
Applicant-Appellant,

SECURITIES AND EXCHANGE COMMISSION, *Plaintiff,*

v.

MORGAN, KENNEDY & CO., INC.;
IRWIN RUDNET AND GERALD RUDNET, *Defendants-Appellees.*

CLAIM OF READING BODY WORKS, INC.
PROFIT SHARING PLAN TRUST, *Claimant-Appellee.*

On Appeal from the United States District Court for the Southern District of New York

BRIEF OF APPELLANT SECURITIES INVESTOR PROTECTION CORPORATION

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INDEX

TABLE OF CASES

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PRELIMINARY STATEMENT

This is an appeal from a memorandum order of Honorable Marvin E. Frankel entered on June 10, 1975 (CCH Fed. Sec. L. Rep. ¶ 95,228) affirming an order of Bankruptcy Judge Roy Babitt entered on February 14, 1975. The Bankruptcy Judge's opinion is reported at CCH Fed. Sec. L. Rep. ¶ 94,972. Both opinions are reproduced in the Appendix (A 50-60). Neither has yet been officially reported.

STATEMENT OF ISSUE PRESENTED FOR REVIEW

In a proceeding to liquidate a broker-dealer under the Securities Investor Protection Act of 1970 ("1970 Act") the Securities Investor Protection Corporation ("SIPC") is authorized to advance a maximum of $50,000 to satisfy the "net equity" of each customer's securities account. The question presented on this appeal is:

> Whether a trust account maintained by the trustees of an industrial employee profit-sharing plan is protected to a maximum of $50,000 irrespective of the number of employees participating in the plan, or whether it is entitled to $50,000 maximum for each employee (here 108) on the theory that every employee is a separate customer of the broker-dealer.

SIPC respectfully submits that the terms and purposes of the 1970 Act will support only the former conclusion, and that the order of the district court should therefore be reversed.

NATURE OF CASE, COURSE OF PROCEEDING AND DISPOSITION BELOW

This appeal arises in a proceeding for the liquidation of Morgan, Kennedy & Co., Inc. ("Debtor") under the 1970 Act (15 U.S.C. §§ 78aaa *et seq.*) [1] Eugene L. Bondy, Jr. ("Bondy") is the trustee for the liquidation of the Debtor. The three trustees ("Trustees") of the trust ("Trust") created under the Profit Sharing Plan ("Plan") established by Reading Body Works, Inc. ("Reading") filed a claim for approximately $133,000. Their claim purported to be on behalf of each of the 108 employee-participants in the Plan ("Reading's Employees"). Thereafter, Bondy filed an application for an order (i) designating the Trustees' claim as the individual claims of Reading's Em-

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[1] Hereinafter all references to sections of the 1970 Act will be to Title 15 of the United States Code.

ployees, and (ii) determining that each of them was a separate "customer" of the Debtor entitled to $50,000 maximum protection under the 1970 Act. The Trustees joined in Bondy's application, and SIPC opposed. Bankruptcy Judge Babitt granted Bondy's application and District Judge Frankel affirmed.

STATEMENT OF FACTS

As the District Court noted (A 58) the material facts are undisputed.

The Nature of the Trust and Reading's Employees' Interest Therein

The Trust was created almost 20 years ago as a funding vehicle for the Plan. The Plan was standard, qualified under the Internal Revenue Code, and was supported *entirely* by Reading's contributions to the Trust. Reading's Employees derived benefits based solely on service in Reading's employ.[2] Discharge for certain causes worked a forfeiture of all rights. Only "vested" benefits were payable on termination of employment for other reasons.[3] The Plan was terminable by Reading at any time.

Neither Reading nor Reading's Employees had any title to, or direct interest in, the assets of the Trust. The Trustees held title to those assets, with the sole power to hold, invest and reinvest. They were empowered to act *only* upon concurrence of a majority. Payments to Reading's Employees were to be made upon the written order of the committee responsible under the Plan for its administration.

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2 The Reading's Employees were assigned "credit units" on each anniversary date of the Plan. A value was assigned to the "credit units" in the proportion they bore to the total "credit units" of all Reading's Employees based on the value of the assets in the Trust.

3 A formula was established whereby increasing percentages of an employee's total "credit units" vested over a period of ten years as a member of the Plan.

The Trustees' Account with the Debtor

The Trustees' account with the Debtor was opened by the Trustees in December, 1972. Control over investment decisions was exercised solely by the Trustees. They communicated regularly with the Debtor with respect to all transactions. When this liquidation proceeding was commenced, the Debtor's books and records reflected a cash credit balance in the Trustees' account in the sum of $133,-051.15.

OPINIONS BELOW

Bankruptcy Judge

The essence of the Bankruptcy Judge's Opinion (A 50-54), apparently approved by the District Judge, is set forth in the following paragraph:

> "Since Congress, in enacting the SIPA, meant to protect the innocent investors, I have no doubt that the word 'customer' should be read to include the individual beneficiaries of the Profit Sharing Trust. In effect, each beneficiary maintained his own account with Morgan, Kennedy and it is quite irrelevant that books of this stockbroker carried the Trust entity as the 'owner' of the account, or, for its own bookkeeping purposes, as its customer." (A 52)

This conclusion was not based on any meaningful analysis of the history, derivation or language of the 1970 Act. Support was based solely upon (i) analogy to the coverage thought to be afforded bank depositors under the Federal Deposit Insurance Act ("FDIA") [12 U.S.C. § 1811 *et seq.*] and (ii) reference to SIPC's Series 100 Rules.

District Judge

In his opinion (A 58-60) the District Judge acknowledged:

> "The statute, as a purely textual matter, favors the appellant [SIPC]." (A 58)

However, he then said:

> "When the underlying policies and relevant analogies are considered, the balance tips the other way, as Judge Babitt held."

The District Judge supplied no explanation of the "underlying policies and relevant analogies" but did make certain observations (discussed *infra*). One warrants emphasis. He stated that although the relevant statutory provisions supported SIPC's position, *i.e.*, that the Trustees' account was protected as the account of one customer,

> "It is scarcely an unbearable wrench to include employees for whom the Trust existed as such 'persons' [customers of the Debtor]."

SIPC respectfully submits that however bearable the wrench might be, the decision below constitutes reversible error as a clear departure from the plain terms of the 1970 Act and the intent of Congress.

STATUTES INVOLVED

The principal operative sections of the 1970 Act are those which prescribe the limits of protection and define the controlling statutory terms, *i.e.*, "customers" and "net equity". They provide, in pertinent part:

Section 78fff(c)(2)(A)(ii)
[Customers]

> " 'customers' of a debtor means persons (including persons with whom the debtor deals as principal or agent) who have claims on account of securities received, acquired, or held by the debtor from or for the account of such persons (I) for safekeeping, or (II) with a view to sale, or (III) to cover consummated sales, or (IV) pursuant to purchases, or (V) as collateral security, or (VI) by way of loans of securities by such persons to the debtor, and shall include persons who have claims against the debtor arising out of

sales or conversions of such securities, and shall include any person who has deposited cash with the debtor for the purpose of purchasing securities, but shall not include any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor;"

Section 78fff(c)(2)(A)(iv)
[Net Equity]

"'net equity' of a customer's account or accounts means the dollar amount thereof determined by giving effect to open contractual commitments completed as provided in subsection (d), by excluding any specifically indentifiable property reclaimable by the customer, and by subtracting the indebtedness, if any, of the customer to the debtor from the sum which would have been owing by the debtor to the customer had the debtor liquidated, by sale or purchase on the filing date, all other securities and contractual commitments of the customer, and for purposes of this definition, accounts held by a customer in separate capacities shall be deemed to be accounts of separate customers;"

Section 78fff(f)
[Limits of Protection]

"(1) Advances for Customers' Claims.—In order to provide for prompt payment and satisfaction of the net equities of customers of debtor, SIPC shall advance to the trustees such moneys as may be required to pay or otherwise satisfy claims in full of each customer, but not to exceed $50,000 for such customer;

"(A) insofar as all or any portion of the net equity of a customer is a claim for cash, as distinct from securities, the amount advanced by reason of such claim to cash shall not exceed $20,000;

"(B) a customer who holds accounts with the debtor in separate capacities shall be deemed to be a different customer in each capacity;"

ARGUMENT

The Trust Acting Through Its Trustees, Not the Reading Employees, Was the "Customer" with an Account Whose "Net Equity" Was Protected by SIPC's Funds as Those Terms Are (i) Defined in the 1970 Act, (ii) Used in the Ordinary Parlance of the Industry and (iii) Commonly Understood in the English Language.

When Congress enacted the 1970 Act it clearly intended to protect securities "customers" in the conventional sense, allotting $50,000 maximum protection to each "customer". There is literally nothing in the statute or its legislative history which supports the idea that Reading's Employees who had no dealings whatever with the Debtor, and may not even have known of the trust account with the Debtor, should nevertheless be considered the Debtor's "customers". Such a proposition would confound any broker-dealer (or any businessman), and it is clear that Congress did not intend such an unorthodox application of the term.

The definitions of "customer" and "net equity" were not the unique contrivances of the 1970 Act. As this Court and others have held, those definitions are derived (*in haec verba* for purposes of this issue) from section 60e of the Bankruptcy Act, 11 U.S.C. § 96e.[4] When section 60e was enacted it had nothing more exotic in mind than the usual cash and margin customers of a stockbroker. The 1970 Act adopted that definition. Thus, both the Senate and House Reports stated in precisely the same words:

> "In addition, the bill uses certain terms defined in section 60e *with the meanings there established*, except as further defined in the bill." (Emphasis added) [5]

[4] See, *e.g.*, *SEC* v. *F. O. Baroff Co., Inc.*, 497 F.2d 280 (2d Cir. 1974); *SEC* v. *Aberdeen Securities Co., Inc.*, 480 F.2d 1121 (3d Cir.), *cert. denied*, 414 U.S. 1111 (1973); *SEC* v. *Kenneth Bove & Co., Inc.*, 378 F. Supp. 697 (S.D.N.Y. 1974); *SEC* v. *Albert & Maguire Securities Co., Inc.*, 378 F. Supp. 906, 911 (E.D. Pa. 1974).

[5] S. Rep. No. 91-1218, 91st Cong., 2d Sess. 10 (1970) ("Senate Report"); H.R. Rep. No. 91-1613, 91st Cong., 2d Sess. 9 (1970) ("House Report"); See also Senate Report at 13 and House Report at 10, 20.

The adoption of section 60e concepts represented a "studied decision" to abandon the FDIC approach reflected in earlier bills (discussed *infra* at 15), a decision prompted largely by the Securities and Exchange Commission ("SEC") and the securities industry itself.[6] Section 35 (m)(10)(A) of the bill jointly drafted by the SEC and the industry, which formed the basis of the 1970 Act, incorporated the section 60e definitions by reference.[7] The 1970 Act restated them.

The importance of this issue, in light of its dramatic impact upon the funds of SIPC,[8] warrants discussion of the history and purpose of section 60e.

Legislative history, purpose and effect of Section 60e

Prior to section 60e the common law of the several states largely determined the rights of margin and cash customers in stockbroker bankruptcy proceedings. Both types of customers were relegated to the status of general creditors if they could not trace their securities under contemporary tracing doctrines. The rights of margin customers varied depending upon the jurisdiction; most treated them as pledgors of the margin securities (New York Rule) while some treated them as having a mere debtor-creditor relationship with the stockbroker (Massachusetts Rule).[9] In the final analysis, various principles were applied by the courts which made the rights of margin and cash custom-

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6 Hearings on S. 2348, S. 2988, S. 2989 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 91st Cong., 2d Sess. 255-257, 267-268 (1970) ("Senate Hearings").

7 Hearings on H.R. 13308, H.R. 17585, H.R. 18081, H.R. 18109, H.R. 18458 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 2d Sess. 324 (1970) ("House Hearing"); Senate Hearings at 261.

8 In this particular case the view of the courts below in a potential call on SIPC's funds of \$5,400,000 (\$50,000 × 108). Although the actual drain would be a fraction of that because of the size of the account, some trust and similar accounts would convert the potential into reality.

9 An excellent discussion may be found in Smith, *Margin Stocks*, 35 Harv. L. Rev. 485 (1922).

ers depend largely upon fortuitous circumstances which affected their ability to trace and reclaim their securities.[10] The law respecting rights of margin and cash customers in bankruptcy came under heavy criticism by numerous commentators.[11] This criticism led to the enactment of section 60e as part of the Chandler Act.

There can be absolutely no question that section 60e was intended *solely* to overcome the existing inequities which the common law had visited upon margin and cash customers in the conventional sense of the term "customer." However there was no intention, or for that matter any need, to define "customers" in a unique and unorthodox manner. This is clear from the legislative history,[12] and has consistently been so understood by commentators,[13] the SEC[14] and the courts.[15] One commentator who was involved in the legislative process observed:

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10 A very helpful summary may be found *In re* J. C. Wilson & Co., 252 Fed. 631 (S.D.N.Y. 1917).

11 Hagar, *The Bankruptcy Law as Applied to Stockbrokerage Transactions*, 30 YALE L.J. 488 (1921); Note, "*The Rights of a Customer in Collateral Security Given a Stockbroker*, 22 COL. L. REV. 155 (1922); Oppenheimer, *Rights and Obligations of Customers in Stockbrokerage Bankruptcies*, 37 HARV. L. REV. 860 (1924); McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 341, 383-385 (1927); Holohan, *Contribution Among Securities Pledged by a Defaulting Stock Broker*, 4 SO. CAL. L. REV. 1 (1930); McLaughlin, *Aspects of the Chandler Bill to Amend the Bankruptcy Act*, 4 U. CHI. L. REV. 485 (1939).

12 H.R. Rep. No. 1409, 75th Cong., 1st Sess. 31 (1937); House Hearings on H.R. 6439, 8046 Before the House Comm. on the Judiciary, 75th Cong., 1st Sess. 125-131 (1937); Analysis of H.R. 12889, 74th Cong., 2d Sess. 192-93 (Comm. Print 1936).

13 WEINSTEIN, THE BANKRUPTCY LAW OF 1938, 122 *et seq.* (1939) (hereinafter Weinstein); Gilchrist, *Stockbrokers' Bankruptcies: Problems Created by the Chandler Act*, 24 MINN. L. REV. 52 (1939); Comment, *The Bankrupt Stockbroker: Section 60(e) of the Chandler Act*, 39 COL. L. REV. 485 (1939).

14 SEC Special Study, Pt. I, at 410 *et seq.*

15 See, e.g., *Tepper* v. *Chichester*, 285 F.2d 309 (9th Cir. 1960); *Gordon* v. *Spalding*, 368 F.2d 327 (5th Cir. 1959); *In re McMillan, Rapp & Co.*, 123 F.2d 428 (3d Cir. 1941); *SEC* v. *First Securities Co. of Chicago*, 366 F.Supp. 367 (N.D. Ill. 1973), *aff'd*, 507 F.2d 417 (7th Cir. 1974).

"This new subdivision is intended to make the law uniform and to avoid inequities in distribution. Upon the bankruptcy of a stockholder, all margin and cash customers are treated as a single class and the securities and proceeds on hand for the purchase or from the sale of the securities of such customers are set up into a single and separate fund, to be distributed, except as otherwise provided in this subdivision, pro rata among such margin and cash customers, according to their respective net equities in their trading accounts. However, a proper exception is made in favor of customers whose moneys or securities, or the proceeds thereof, have been specifically earmarked and set aside for them by the broker more than four months before bankruptcy, or, if within such four months' period, while solvent." [16]

Section 60e was intended ". . . to correct a very definite and well-recognized situation." *In re McMillan, Rapp & Co.,* 123 F.2d 428, 431 (3d Cir. 1941). It was class legislation, constitutionally justified because founded upon a rational basis. *SEC* v. *Milner,* 474 F.2d 162, 166 (1st Cir. 1973). It was for the benefit of margin and cash customers, as a class, who entrusted securities to their broker.[17] It contemplated transactions "in the form usual to dealings" between the customer and his broker and relates only to securities held for the customer's account.[18]

Section 60e permitted limited tracing by customers. Thus, "cash customers" were entitled to reclaim fully-paid secu-

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[16] Weinstein, *supra* note 13, at 122. The author noted: "These comments and the comments which follow under this subdivision e are derived from an excellent note prepared by Harry Zalkin, Esq., a member of the New York bar, for the House Committee Print (H.R. 12889, 74th Congress, 2nd Session, May 2, 1936)". *Id.*

[17] See, e.g., *SEC* v. *First Securities Co. of Chicago,* 507 F.2d 417, 420-22 (7th Cir. 1974); *In re Barraco and Co.,* 478 F.2d 517, 520 (10th Cir. 1973); *Mardick* v. *Stover,* 392 F.2d 561, 564 (9th Cir. 1968); *Bush* v. *Masiello,* 55 F.R.D. 72, 75 (S.D.N.Y. 1972).

[18] Cases cited note 15 *supra,* especially *SEC* v. *First Securities Co. of Chicago,* 507 F.2d at 421.

rities which were their "specifically identifiable property" within the statutory definition [11 U.S.C. § 96e(4)]. To adjust the previous inequities, all other property (as defined) held by the stockbroker for customers was classified as a "single and separate fund" for the benefit of all customers as a "single and separate class of creditors" [11 U.S.C. § 96e(2)]. Each customer was entitled to his pro rata share of that fund based on the "net equity" of his account, as defined [11 U.S.C. § 96e(1)]. The terms "customer" and "cash customer" were in a manner consistent with common industry usage. The definition of "customer" was merely ". . . designed to cover every form of transaction dealt with" under section 60e [19]—the customary activities in a typical securities account.

The stark reality is that there was no need under section 60e to define customers in an unconventional or bizarre way. Obviously, only the conventional customer, the owner, could claim "specifically identifiable" securities. Further, ratable participation in the "single and separate fund" was based on the "net equity" of the customer's account. In the case of a trust account, that participation could not be affected by the number of persons beneficially interested in the trust, or for that matter the number of trustees. The "net equity" was based only on the value of the account on the date of bankruptcy.

The 1970 Act

The background and purposes of the 1970 Act are familiar to this court and require no extensive discussion.[20]

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19 Weinstein, *supra* note 13, at 123.

20 See *Exchange National Bank of Chicago* v. *Wyatt*, — F.2d — (2d Cir. 1975); *SIPC* v. *Charisma Securities Corp.*, 506 F.2d 1191 (2d Cir. 1974); *SEC* v. *Packer, Wilbur & Co., Inc.*, 498 F.2d 978 (2d Cir. 1974); *SEC* v. *F. O. Baroff Co., Inc.*, 497 F.2d 280 (2d Cir. 1974); *SEC* v. *Oxford Securities, Ltd.*, 486 F.2d 1396 (2d Cir. 1973); *SEC* v. *Alan F. Hughes, Inc.*, 481 F.2d 401 (2d Cir.), *cert. denied*, 414 U.S. 1092 (1973); *SEC* v. *Alan F. Hughes, Inc.*, 461 F.2d 974 (2d Cir. 1972).

They have recently been summarized in *SIPC* v. *Barbour,* 95 S. Ct. 1733 (1975).

The 1970 Act was an ". . . engraftment of insurance provisions upon the preexisting Section 60(e) bankruptcy provisions applicable to stockbrokers, II U.S.C. § 96(e)." *SEC* v. *Aberdeen Securities Co., Inc., supra* at 1123. A liquidation proceeding under the 1970 Act conforms substantially to traditional stockbroker bankruptcy proceedings. *Cf. Exchange National Bank of Chicago* v. *Wyatt, supra* note 20. The concepts of "customer," "cash customer," "specifically identifiable property," "net equity" and "single and separate fund" have been carried forward in section 78fff(c)(2) of the 1970 Act. As already demonstrated, the 1970 Act was not intended to vary the meaning of those terms except as otherwise "further defined."

With minor clarifying word changes, the material portions of the definition of "customers" [§ 78fff(c)(2)(A)(ii)] conforms exactly to the definition in section 60e.[21] The definition of "net equity" [§ 78fff(c)(2)(A)(iv)] was likewise taken *in haec verba* from section 60e except for three changes of which two are relevant.[22] While section

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21 While not presently material, the definition was changed in two substantive ways. The definition now specifically includes persons who had deposited cash for the purpose of purchasing securities, thereby resolving an ambiguity under section 60e. See Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, Pt. 1, 88th Cong., 1st Sess. 416 (1963). The definition now specifically excludes persons to the extent their claims relate to capital contributions or subordinated loans to the Debtor.

22 The other gives effect to open contractual commitments completed as provided in section 78fff(d). That section authorizes the trustee to complete interbroker transactions with the use of SIPC's funds if necessary. This authority was designed to avoid the so-called "domino effect," namely, the chance that the demise of a member might precipitate the failure of one or more broker-dealers. House Report at 9; Senate Report at 4, 11; Senate Hearings at 147. See also *SEC* v. *Aberdeen Securities Co., Inc.,* 480 F.2d 1121, 1125 (3d Cir.), *cert. denied,* 414 U.S. 1111 (1973). Such transactions may involve a customer's account and must therefore be taken into account in calculating his "net equity". That was unnecessary under section 60e because the completion of such open transactions was not authorized.

60e referred only to the "account" of a customer, the 1970 Act definition refers to the "account or accounts" of a customer. This was designed to limit the maximum protection to $50,000 *per customer.*[23] Correspondingly language was added to assure separate protection to different accounts maintained by the same person acting "in separate capacities." There is nothing whatever in the "customer" or "net equity" definitions in the 1970 Act to suggest that Congress meant to define customers so as to include persons other than the conventional cash or margin customers contemplated by section 60e. In short, there is nothing to suggest that non-customers are now customers.

The foregoing is not altered by section 78fff(f)(1) of the 1970 Act which accomplishes the ". . . engraftment of insurance provisions upon the preexisting Section 60(e) bankruptcy provisions . . ." *SEC* v. *Aberdeen Securities Co., Inc., supra.* That section does not alter, in the slightest, the definitions and concepts embodied in section 78fff (c)(2)(A). It merely authorizes SIPC to advance funds (within specified limits) to the trustee in liquidation for the purpose of satisfying "the net equities of customers." As a result, customers are no longer dependent upon the aggregate customer property which is found by the trustee in liquidation, *i.e.,* the "single and separate fund." Their pro rata interests in that fund are the same as under section 60e, but SIPC's funds are now available to assure that "net equities" will be satisfied up to $50,000. To the extent it advances funds to satisfy "net equities," SIPC is subrogated to the rights of customers both in the "single and separate fund" and the general estate [§ 78fff(f)(1)].

It is impossible to read the definition of "customer" as did the courts below without doing violence to the statutory language. The definition itself refers to "persons

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23 The $50,000 protection afforded by section 78fff(f)(1) is based on a customer's "net equity". Without this change in the "net equity" definition, each customer might have been deemed protected to $50,000 for each of his accounts.

with whom the debtor deals as principal or agent" (emphasis added)[24] and refers to persons with "claims" (creditors of the debtor) on account of various specified transactions with the debtor which the Reading Employees never had, and could never have had, with respect to the Trust's account. Among other things the "net equity" definition provides a formula which includes subtraction of "the indebtedness, if any, of the customer to the debtor from the sum which would have been owing by the debtor to the customer". That definition would make no sense at all except as applied to a person "with whom the debtor deals". The notion of a conventional customer pervades section 78fff in its entirety. For example, "customers" are a single and separate class of creditors" to whom the trustee in liquidation is authorized to deliver securities held in their accounts [subd. (c)(2)(B)]; the trustee in liquidation must give notice of the proceeding to "customers of the debtor as their addresses shall appear from the debtor's books and records" [subd. (e)]; and, obviously, the liquidating trustee must make payments or deliveries of securities directly to the debtor's customers [subd. (g)]. These and other provisions of section 78fff are as obvious as section 60e in their contemplation of a conventional securities customer as a "customer" with the statutory definition. That is the usual meaning ascribed to the term in the ordinary parlance of the securities industry, a factor which should be accorded considerable weight. *SEC* v. *Kenneth Bove & Co., Inc.*, 378 F. Supp. 697, 701 (S.D.N.Y. 1974).

When Congress meant to provide protection based on persons more remote than a debtor's conventional securities customers it did so unequivocally. Thus, although customers who are broker-dealers or banks are denied protection from SIPC's funds (though participants in the

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[24] Section 60e referred only to customers of "stockholders", as a result of which serious doubt existed as to whether one could be deemed a customer with respect to transactions as to which the stockholder acted as principal or dealer. *Gordon* v. *Spalding*, 268 F.2d 327, 332 (5th Cir. 1959). This language was incorporated in the 1970 Act to eliminate that doubt. Senate Hearings at 261.

"single and separate fund") section 78fff(f)(1)(B) specifically authorizes up to $50,000 protection for each of their customers on whose behalf they had transactions in their account with the debtor. For this purpose each such customer is "deemed a separate customer of the debtor". Congress made no similar provision in the case of fiduciary accounts such as that involved here. This was not mere oversight. The 1970 Act recognized that fiduciary accounts are a part of the business of broker-dealers. For that purpose it provided that a customer who maintains multiple accounts "in separate capacities" shall be deemed a "separate customer" in each capacity [§ 78fff(c)(2)(A)(vi)], and it therefore authorized protection from SIPC's funds up to $50,000 for each capacity [§ 78fff(f)(1)(B)]. These provisions, especially in light of the special provisions for customers of broker-dealers and banks, conclusively demonstrate that Congress made a conscious decision to accord the Trustees' account here a maximum of $50,000 protection. There is clearly no authority to multiply that by the number (108) of Reading's Employees.

Apart from the plain language of the 1970 Act and its relationship to section 60e, its legislative history includes conclusive proof of Congress' refusal to expand protection in the circumstances presented here. Several bills preceded the one eventually enacted as the 1970 Act. The four earliest bills were substantially modeled after the FDIA (an attempt later discarded, discussed below).[25] One of them would have expanded protection beyond $50,000 (up to $250,000) based on "the beneficial interest of five or more natural persons"[26] and two others would

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[25] S. 2348, and as amended, H.R. 13308, H.R. 17585.

[26] "(5) The term 'insured customer account' means (a) the net amount due any customer from his account maintained with an insured broker or insured dealer, less any part thereof which is in excess of $50,000 or such larger amount as shall be determined by rule or regulation of the Corporation; or (b) the net amount due any institution or entity which represents the beneficial interest of five or more natural persons, less any part thereof which is in excess of $250,000 or such larger amount as shall be determined by rule or regulation of the Corporation". S. 2348, as amended by April 9, 1970.

have provided $50,000 for each person on whose behalf a customer was "acting as agent".[27] These departures from the concept of limited protection per conventional customer were plainly rejected by subsequent bills [28] and, eventually, the 1970 Act. The legislative debates clearly show that the conventional securities customer was all that anyone had in mind in the class to be protected. The phrases "customer", "account" and "investor" were used interchangeably in the course of hearings by securities industry representatives,[29] members of Congress,[30] the SEC [31] and other representatives of the federal government.[32] The testimony of the then Chairman of the SEC underscores that this legislation was intended to provide $50,000 protection

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27 ". . . in the case of a person acting as agent who transacts business for third parties through an account or accounts with a broker, dealer, or member of a national securities exchange, for purposes of the $50,000 limitation, the term customer shall not be limited by the number of such accounts but shall include each such third party insofar as the claims of such third parties are ascertainable from the books and records of either the debtor or the person acting as agent made available to the trustee or are otherwise determined to the satisfaction of the trustee." S. 3988; S. 3989.

28 H.R. 18458; H.R. 19333; S. 2348 as reported out.

29 Senate Hearings at 11-12, 26-27, 36, 40, 42-45, 178-179, 187, 206, 208-209, 219-220, 225, 227; House Hearings at 166, 306-310, 352-354. A prominent representative of the securities industry referred to risks ". . . run by the investor who may have just walked off Main Street . . ." [Senate Hearings at 42].

30 Senate Hearings at 142-144, 252-253; House Hearings at 233, 373-374; see also Senate Report at 1-4, 11-14; House Report at 1-4, 8-10. To illustrate, one member of Congress spoke of ". . . the average person picking up the phone, calling his broker . . ." [House Hearings at 233].

31 Senate Hearings at 8-10, 16, 257; House Hearings at 149-154, 226-228, 230, 328, 333-334, 367-368, 370.

32 Senate Hearings at 245-246. See also Senate Report at 1-4, 11-14; House Report at 1-4, 8-10; H.R. Rep. No. 91-1788 (Conference Report) 91st Cong., 2d Sess. 1, 24, 26 (1970).

for each securities "customer" in the ordinary industry sense.[33]

That the definition of customer does not abandon the normal usage of the term is further established by numerous cases under the 1970 Act. Thus in *SEC* v. *F. O. Baroff Co., Inc.*, 497 F. 2d 280 (2d Cir. 1974) this Court firmly delimited customers as "securities traders", "the trading

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33 There was concern on the part of some Members of Congress as to whether a limit of $50,000 protection would be adequate to cover most customers' accounts with brokers. The relevant questions and answers at one point were as follows [House Hearings at 339-340]:

"MR. TAYLOR: (advisor to subcommittee chairman). Do you have any estimate of the percentage of existing customer accounts that would be covered under the $50,000 limitation of the bill?

MR. BUDGE: I do not, Mr. Taylor. If we could furnish it for the record, we would be glad to.

MR. MOSS: Without objection, the record will be held open at this point to receive it. I think it is important to receive that information.

(The following information was received for the record:)

CUSTOMER ACCOUNTS COVERED UNDER THE ADMINISTRATION'S PROPOSED BILL DATED JULY 9, 1970

We believe that the vast majority of investors would be fully protected by the $50,000 coverage of the proposed bill. Our own general impression to this effect has been supported by a survey made by the Midwest Service Corporation. It surveyed 553,000 accounts of 94 firms for whom it keeps books and records. All of these firms are New York Stock Exchange members. The Service Corporation advises us it believes the survey represents an accurate cross-section of all customer accounts and would be consistent with the results of a larger sampling.

It found that 94.5% cash and margin accounts would be fully covered by the $50,000 limitation. It is interesting that so large a majority of accounts represents only 7.2% of the $1.5 billion total dollar value of such accounts. 99.6% of the accounts with customers' free credit balances would be covered as to those securities and 7.5% of the $156 million they represent in this survey would be covered. 96.3% of the accounts with customers' securities in brokers' custody would be fully covered as to those securities; and 7.1% of the total value of customers' securities in broker's custody would be protected by the $50,000 coverage.

MR. TAYLOR: I gather there is no doubt in your mind that the $50,000 figure is adequate, and I only ask this because I believe you indicated in the earlier Senate hearings you had some doubt about it 2 months ago.

MR. BUDGE: We feel that $50,000 figure is a reasonable figure to have in the statute."

That the $50,000 maximum protection was intended to apply to securities accounts with the broker was restated during the legislative hearings. (House Hearings at 376, 379-380; Senate Hearings at 257).

customer", "the customer as investor and trader" and "the customer as investor". Reading's Employees are none of these, nor are they in the "fiduciary relationship between a broker and his public customer" which this Court found so essential to "customer" status. And so, numerous cases have considered one's actual entrustment of his cash and securities to his broker as a critical prerequisite to "customer" status.[34] To illustrate, in one case the court held:

> "One can be a customer only if his property has been 'received, acquired or held' by the stockbroker as of the filing date. Congress intended to protect only those who entrusted property to the stockbroker. (citing cases)." *SIPC* v. *Associated Underwriters, Inc.*, C276-73 (D. Utah, May 7, 1975).

One Court of Appeals expressed the proposition thusly: "The Securities Investor Protection Act was enacted in response to the need to protect the customers of securities brokers and dealers which might fail, *thereby jepardizing the cash and securities that customers had left on deposit with the firm.*" *SEC* v. *Guaranty Bond & Securities Corp.*, 496 F. 2d 145, 147 (6th Cir. 1974), *rev'd on other grounds sub. nom. SIPC* v. *Barbour,* 95 Sup. Ct. 1733 (1975) (Emphasis added). Clearly only the Trust, acting by its trustees through their account with the Debtor, fall within the foregoing requirements so necessary to any rational definition of "customer".

The basic issue presented here has arisen in analogous situations under the 1970 Act. *See, e.g., SIPC* v. *J. Sha-*

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34 *SEC* v. *F. O. Baroff Co., Inc.*, 497 F.2d 280, 283 (2d Cir. 1974); *SIPC* v. *Associated Underwriters, Inc.*, C 276-73 (D. Utah, May 7, 1975); *SEC* v. *Kelly, Andrews & Bradley, Inc.*, 385 F. Supp. 948, 951 (S.D.N.Y. 1974); *SEC* v. *Kenneth Bove & Co., Inc.*, 378 F. Supp. 697 (S.D.N.Y. 1974); *SEC* v. *S. J. Salmon & Co., Inc.*, 375 F. Supp. 867, 871 (S.D.N.Y. 1974); *SEC* v. *Ridgewood Securities Corp.*, Civil No. 72-2053 (S.D. Fla. 1974) (Claim of Benjamin D. Gilbert); *SEC* v. *Horizon Securities Corp.*, Civil No. 72-5112 (S.D.N.Y. May 31, 1974) (Claim of Charon Styx Associates); *SEC* v. *S. J. Salmon & Co., Inc.*, Civil No. 72-560 (S.D.N.Y., June 13, 1973) (Claim of Galaxy Fund, Inc.).

piro Co., 473 Civ. 212 (D. Minn., March 17, 1975) (Owens, B. J.); *SIPC* v. *Dickinson, Rothbart & Co., Inc.*, 78 Civ. 1105 (S.D.N.Y., February 28, 1975) (Herzog, B. J.); *SEC* v. *Horizon Securities, Inc.*, (Claim of Charon Styx Associates) 72 Civ. 5112 (S.D.N.Y., May 31, 1975) (Herzog, B. J.). Each supports SIPC's position here, but the *Shapiro* case is worthy of special notice. In that case the court rejected an executrix' contention that the two residuary legatees of the estate she represented were separate customers of the debtor within the meaning of the 1970 Act.[35]

Reliance below on analogy to FDIC

Bankruptcy Judge Babitt's reliance on a supposed analogy to the insurance of bank depositors by the FDIC is unsupportable. Congress specifically rejected that approach, as already noted (*supra* at 15). The earliest bills, patterned after the FDIC, were sharply criticized by representatives of that industry and by the SEC[36] as being inappropriate to the securities industry. Among the

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[35] The court held: "It seems evident that the mentioned provisions are intended to deal with situations where one person may hold two or more accounts, each account in a different and separate capacity such as fiduciary for another, as participant in a joint account, or simply as the holder of a several account. There is nothing in the language of the provisions purporting to deal with the division of one account into several parts. The whole purpose of the statute is to provide some certainty of extent to which SIPC protection is extended. It would be most unusual for the statute to provide a fixed monetary limit per account while extending limitless protection to fiduciary or trust accounts, dependent only on the number of ultimate beneficiaries, a fact not disclosed on the face of the account. I conclude that as a matter of plain meaning, the provisions are not susceptible of the suggested construction and since there is, in fact, only one account which is the subject of the present claim, the maximum limitation of $20,000 [the claim was for cash] governs."

[36] Senate Hearings at 29, 175-177, 185, 191, 210-212; House Hearings at 221-222. One prominent industry representative observed: "Models chosen from one field of activity rarely fit exactly the needs of another field. I do not think the pattern of the FDIC fits the securities industry very well." Senate Hearings at 29.

problems were the many differences between bank accounts and securities accounts, and eventually the SEC made a "studied decision" to abandon the FDIC concept and, instead, to adopt the basic provisions of section 60e of the Bankruptcy Act.[37] The result was the bill which, with some modifications, became the 1970 Act.[38]

While it seems clear that there is no legitimate analogy between SIPC and the FDIC for purposes of this issue, it is appropriate to stress the differences between the 1970 Act and the FDIA which make attempted analogy all the more inappropriate. The major relevant difference is in the definition of terms in each Act and the power of the FDIC to establish the limits of protection. While the 1970 Act carefully sets forth the limits of protection and relevant definitions, FDIC coverage is largely the product of regulations promulgated by the FDIC pursuant to broad discretionary authority given to it under 12 U.S.C. § 1813 (m).[39] Pursuant to that authority the FDIC has promulgated rules fleshing out the skeletal framework of insurance coverage provided in the FDIA itself. On the other hand, the relevant definitions and limits of protection set forth in the 1970 Act are complete in and of themselves. They need no rules to flesh them out and SIPC, unlike the FDIC, has no such rule-making authority.

Other differences between the FDIC and SIPC abound. The FDIC is an instrumentality of the United States Government. SIPC is not [§ 78ccc(a)(1)]. The FDIC has

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37 Senate Hearings at 255-257, 267-268.

38 H.R. 18458; reprinted at Senate Hearings at 283 *et seq.*

39 The operative term in the FDIA—"insured depositor"—is undefined in the FDIA. The cited section leaves the definition of the term to the FDIC by providing: "For the purpose of clarifying and defining the insurance coverage under this subsection and subsection (i) of section 1817 of this Title, the corporation is authorized to define, with such classifications and exceptions as it may prescribe, terms used in those subsections, in subsection (p) of this section, and in subsections (a) and (i) of section 1821 of this Title and the extent of insurance coverage resulting therefrom."

vast regulatory authority over banks. SIPC has no regulatory authority over its members. Banks are not automatically insured by the FDIC and the insurance protection may be terminated by the FDIC if it finds that an insured bank has engaged in unsafe or unsound practices or is in an unsafe or unsound condition [12 U.S.C. § 1818 (a)]. Membership in SIPC, on the other hand, is automatic [§ 78ccc(a)(2)] and SIPC has no power to terminate that membership no matter what unsafe or unsound practices the broker-dealer may engage in. This difference alone was more than sufficient to justify the clear congressional determination to limit protection in the manner it did.

Reliance below on SIPC's rules

Contrary to the views of the courts below, SIPC's Series 100 Rules [3 CCH Fed. Sec. L. Rep. ¶ 26,667] form no basis whatever for the conclusion they reached. It appears the rules were either misapplied or misunderstood.

The Series 100 Rules serve a very limited purpose. Entitled "Rules Identifying Accounts Of 'Separate Customers' Of SIPC Members", they represent SIPC's effort to publicize its views concerning the proper interpretation and application of sections 78fff(c)(2)(A)(iv) and 78fff (f)(1) of the 1970 Act. These have already been discussed (*supra* at 12 *et seq.*). To summarize, those sections make the maximum protection available to each "separate capacity" in which a customer holds multiple accounts. The "net equity" of accounts held in one capacity is calculated separately (and protected separately) from the "net equity" of accounts held in another capacity. The customer is deemed a "separate" or "different" customer for each "separate capacity". Thus, a customer with both a personal account and a fiduciary account is protected to $50,000 for each.

SIPC's rules do no more than express its construction of these statutory provisions as applied to specific situa-

tions. Thus, Rule 101(b) deals with ordinary agency or nominee situations [40] whereas Rule 104 deals with trust accounts.[41] These and all other parts of the Series 100 Rules merely carry forward the congressional limits of protection to customers of the debtor, as defined, based on the "capacities" in which they hold their accounts. They can hardly be used as justification for exploding the basic statutory definition of "customer" by multiples of beneficial interests whenever and however they appear. Such an approach would be a clear misapplication of SIPC's rules and a definite abuse of the statute they were intended to effectuate. The "separate capacities" provisions in the 1970 Act are a special adjustment of the basic "customer" definition. They cannot provide license for obliterating that definition. It should be noted that the District Court erroneously interpreted Rule 104(c) as looking solely to beneficial interests in trust accounts. The rule, however, suggests only that two or more trust accounts should not be considered as held in "separate capacities" where the trustee, settlor *and* beneficiary are the same in each.

In the final analysis SIPC's rules are hardly determinative of the issue before this Court. They do not have the force or effect of law. They are, at most, interpretative rules rather than legislative rules. See Davis, *Administrative Law Text*, § 5.03 (3d ed. 1972); *Cf. Free* v. *Bland,* 369 U.S. 663 (1962); *Skidmore* v. *Swift & Co.,* 323 U.S. 134

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[40] Rule 101(b) cited below provides: "An account held with a member by an agent or nominee for another person as a principal or beneficial owner shall, except as otherwise provided in the rules of this Series, be deemed to be an individual account of such principal or beneficial owner.

[41] Rule 104(c) cited by the District Court provides: "More than one qualifying trust account may be held with a member on behalf of a trust or trusts which were established by the same testator or settlor and have the same trustee, but where *such* accounts are held for the benefit of the same current beneficiary or beneficiaries, *such* accounts shall be combined so that the maximum protection afforded to *such* accounts in the aggregate shall be the maximum protection afforded to one 'separate customer' of the member." (Emphasis added).

(1944). SIPC's rule-making powers are set forth in section 78ccc(b) which provides: "SIPC shall have the power . . . (3) *subject to the provisions of this Act,* to adopt, amend, and repeal, by its Board of Directors by-laws and rules relating to the conduct of its business and the exercise of all other rights and powers granted to it by this Act". (Emphasis added). SIPC is given no power to vary, by rule or otherwise, the provisions of the 1970 Act, including such critical provisions as the definitions of "customers", "net equity", etc. This is in sharp contrast to the limited power granted to the SEC to vary the definitions of "specifically identifiable property" [§ 78fff(c)(2)(C)(iii)] and "open contractual commitments" [§ 78fff(d)(1) and (2)]. The SEC was given no authority to vary the definitions of "customer" and "net equity". Neither was SIPC. Those definitions must be given the meaning intended by Congress. They may not be altered by extrapolation from SIPC's interpretive rules.

Concluding Argument

The language and legislative history of the 1970 Act, as construed by courts until the decision below, lead to the ineluctable conclusion that Reading's Employees were not customers of the Debtor within the meaning of section 78fff(c)(2)(A)(ii). The Trust was the customer through the joint action of the Trustees whose single account with the Debtor is protected for the "net equity" thereof up to $50,000. The construction adopted below emasculates the relevant provisions of the 1970 Act, contrary to established principles of statutory construction which mandate judicial implementation of clear statutory provisions supported by unequivocal legislative history.[42]

It is apparent that the courts below reached for what seemed to be an equitable result, an effort substantially

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42 *United States* v. *Oregon,* 366 U.S. 643, 648 (1961); *Callanan* v. *United States,* 364 U.S. 587, 596 (1961); *Mastro Plastics Corp.,* v. *N.L.R.B.,* 350 U.S. 270, 285-286 (1946); *United States* v. *Marando,* 348 U.S. 528, 538-539 (1955).

predicated on (i) the general purposes of the 1970 Act and (ii) analogy to the FDIA. The former finds its configuration in precise statutory language and cannot serve as a vehicle to accomplish broader results. The illegitimacy of analogy to FDIA has been conclusively demonstrated. This Court has cautioned not ". . . to exhume ambiguous legislative history [concerning the 1970 Act] in order to create a doubt that is not there." *Exchange National Bank of Chicago* v. *Wyatt,* —— F.2d ——, —— (2d Cir. 1975). To some extent the rationale below failed to heed that admonition.

Whatever might be said of the equity in the plan of Congress, the plan is abundantly clear. As this Court observed in *SEC* v. *Packer, Wilbur & Co., Inc.,* 498 F.2d 978, 983 (2d Cir. 1974):

> "However, arguments based solely on the equities are not, standing alone, persuasive. If equity were the criterion, most customers and creditors of Packer Wilbur, the bankrupt, would be entitled to reimbursement for their losses. Experience, on the other hand, counsels that they will have to settle for much less. SIPA was not designed to provide full protection to all victims of a brokerage collapse. Its purpose was to extend relief to certain classes of customer."

The 1970 Act may not be the ultimate in protection, but its parameters are clear and were within the province of Congress to decide.

In the final analysis the funds of SIPC are to be applied as the Congress intended. But the impact of the decision below cannot be gainsaid. If sustained, the call on SIPC's funds will have been dramatically increased. Unlike the billions at the disposal of the FDIC, as of December 31, 1974 the SIPC Fund was at $60,165,743 after four years of operations, excluding a line of credit of $35,000,000. 4 SIPC Ann. Rep. 16 (1974). The line of credit must be phased out [§ 78ddd(d)(2)]. The fund has yet to reach

the minimum statutory objective of $150,000,000 [§ 78ddd (d)(1) and (2)]. Given the primary congressional purpose to protect the relatively small public investor, constructions of the statute which divert funds to employees of pension trusts, profit-sharing plans and the like cannot be lightly adopted. One such major account could substantially deplete the SIPC Fund. If the account were large enough in this case, the construction adopted below would wipe out almost ten per cent of the SIPC Fund (excluding lines of credit).

CONCLUSION

The Order of the District Court should be reversed and the matter should be remanded with directions to enter an order determining that the account held by the Trust, acting through its Trustees, is the account of one customer of the Debtor entitled to a maximum of $50,000 from SIPC's funds.

Respectfully submitted,

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I am a citizen of the United States and a resident of Maryland; I am over the age of eighteen years and not a party to the within action; my business address is: Byron S. Adams Printing, Inc., 1213 K Street, N.W., Washington, D.C.

On August 28th, 1975, I served the within

IN THE
UNITED STATES COURT OF APPEALS
For the Second Circuit

No. 75-6066

Securities Investor Protection Corporation,
Applicant-Appellant,

Securities and Exchange Commission, Plaintiff,

v.
Morgan, Kennedy & Co., Inc.;
Irwin Rudnet and Gerald Rudnet, Defendants-Appellees.

Claim of Reading Body Works, Inc.
Profit Sharing Plan Trust, Claimant-Appellee.

On Appeal from the United States District Court
for the Southern District of New York

BRIEF OF APPELLANT AND APPENDIX SECURITIES
INVESTOR PROTECTION CORPORATION

on the opposing counsel in said action, by placing two copies each of the Brief and one copy each of the Appendix thereof enclosed in a sealed envelope with postage fully prepaid, in the United States post office mail box at Washington, D.C. addressed as follows:

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I certify (or declare), under penalty of perjury, that the foregoing is true and correct.

Executed on August 28th, 1975, at Washington, D.C.

George M. Bernier

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